

REPORT BY THE  
OFFICE OF THE AUDITOR GENERAL

F-556

CALIFORNIA STUDENT AID COMMISSION  
STATE GUARANTEED LOAN RESERVE FUND  
FINANCIAL AUDIT REPORT  
YEARS ENDED JUNE 30, 1984 AND 1985

NOVEMBER 1985



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November 21, 1985

F-556


Honorable Art Agnos, Chairman  
Members, Joint Legislative  
Audit Committee  
State Capitol, Room 3151  
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the California Student Aid Commission's State Guaranteed Loan Reserve Fund for the years ended June 30, 1984 and 1985.

The fund balance for the Guaranteed Student Loan Program increased by \$13.1 million during the year, resulting in an ending balance of \$85.4 million at June 30, 1985. For fiscal year 1984-85, the State's share of loan defaults significantly increased over fiscal year 1983-84. During fiscal year 1983-84, the State did not participate in the reinsurance of defaulted loans for the entire year; therefore, the increase is primarily due to a full year of participation for 1984-85. However, there has also been a 33 percent increase in the amount of defaults by student borrowers during the current year. The report also discloses that the United States Secretary of Education suspended the reimbursement of administrative costs for the federal fiscal year 1984-85, but this has been offset with additional advances to the fund from the federal government.

Respectfully submitted,

  
for THOMAS W. HAYES  
Auditor General

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## INTRODUCTION

We have conducted a financial audit of the California Student Aid Commission's State Guaranteed Loan Reserve Fund. The California Student Aid Commission (commission) requested this audit to meet its obligation to provide audited financial statements to lenders participating in the California Educational Loan Programs.

The State Guaranteed Loan Reserve Fund reflects the financial activities of three programs: the Guaranteed Loan Program, the State Guaranteed Loan Program, and the California Loans To Assist Students Program. Because the Guaranteed Loan Program has been replaced by the State Guaranteed Loan Program, the Guaranteed Loan Program no longer provides loans and contains only residual activity. The State Guaranteed Loan Program and the California Loans To Assist Students Program are collectively known as the California Educational Loan Programs.

In 1975, Section 69760 of the California Education Code established the State Guaranteed Loan Program; in 1977, the Legislature amended Section 69761.5 of the code to authorize the commission to serve as a guarantee agency for student loans. This program carries out the provisions of the federal Guaranteed Student Loan Program instituted within the federal Higher Education Act of 1965, as amended (P.L. 89-329) and the Education Amendments of 1976 (P.L. 94-482). Also by authority of Section 69760 of the California Education Code, the

commission in 1982 established the California Loans to Assist Students Program. The commission is responsible for guaranteeing federally reinsured loans issued to students and parents for postsecondary education expenses.

The commission has contracted with the E.D.S. Corporation to provide administrative support services from January 3, 1983, to February 28, 1987. These services include processing and approving all student loan applications, collecting insurance premiums, maintaining and managing the loan portfolio, processing claims from lenders, pursuing collections, and preparing reports required by the United States Department of Education.

The State Guaranteed Loan Reserve Fund is supported by federal funds, investment earnings, and insurance premiums paid by student borrowers.

We conducted this audit under the authority vested in the Auditor General by Section 10500 et seq. of the Government Code.



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We have examined the balance sheets of the California Student Aid Commission's State Guaranteed Loan Reserve Fund as of June 30, 1984 and 1985, and the related statements of revenues, expenditures, and changes in fund balance for the years then ended. We made our examinations in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of the California Student Aid Commission's State Guaranteed Loan Reserve Fund at June 30, 1984 and 1985, and the results of its operations and the changes in fund balance for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

OFFICE OF THE AUDITOR GENERAL

A handwritten signature in black ink, appearing to read "Karl W. Dolk".

KARL W. DOLK, CPA  
Deputy Auditor General

Date: October 3, 1985

Staff: Ulrich Pelz, CPA, Audit Manager  
Marianne Pulli Evashenk, CPA  
Robert N. Howe

**CALIFORNIA STUDENT AID COMMISSION  
STATE GUARANTEED LOAN RESERVE FUND  
BALANCE SHEET  
AS OF JUNE 30, 1984 AND 1985**

|  | <u>1984</u>         | <u>1985</u>          |
|--|---------------------|----------------------|
| <b>ASSETS</b>                          |                     |                      |
| Cash                                   | \$ 20,603           | \$ 704,493           |
| Insurance premiums receivable          | 1,017,242           | 1,083,807            |
| Due from other funds                   | 68,339,356          | 87,020,319           |
| Due from federal government            | 10,049,039          | 47,099,140           |
| Equipment                              | <u>102,943</u>      | <u>138,743</u>       |
| Total Assets                           | <u>\$79,529,183</u> | <u>\$136,046,502</u> |
| <br><b>LIABILITIES AND FUND EQUITY</b> |                     |                      |
| <b>Liabilities</b>                     |                     |                      |
| Payable to lenders and students        |                     | \$ 47,594,565        |
| Due to General Fund                    | \$ 6,485,191        | 2,358,742            |
| Due to federal government              | 594,018             | 464,255              |
| Liability for compensated absences     | <u>61,164</u>       | <u>87,537</u>        |
| Total Liabilities                      | <u>7,140,373</u>    | <u>50,505,099</u>    |
| <br><b>Fund Equity</b>                 |                     |                      |
| Investments in fixed assets            | <u>102,943</u>      | <u>138,743</u>       |
| Fund balance                           |                     |                      |
| Reserved for loan defaults             | 42,054,471          | 46,735,420           |
| Designated for federal advances        | 9,126,687           | 14,383,748           |
| Undesignated                           | <u>21,104,709</u>   | <u>24,283,492</u>    |
| Total Fund Balance                     | <u>72,285,867</u>   | <u>85,402,660</u>    |
| Total Fund Equity                      | <u>72,388,810</u>   | <u>85,541,403</u>    |
| Total Liabilities and Fund Equity      | <u>\$79,529,183</u> | <u>\$136,046,502</u> |

See the notes accompanying the financial statements.

**CALIFORNIA STUDENT AID COMMISSION  
STATE GUARANTEED LOAN RESERVE FUND  
STATEMENT OF REVENUES, EXPENDITURES,  
AND CHANGES IN FUND BALANCE  
FOR THE FISCAL YEARS ENDED JUNE 30, 1984 AND 1985**

|   | <u>1984</u>         | <u>1985</u>         |
|---|---------------------|---------------------|
| <b>REVENUES</b>   |                     |                     |
| Insurance premiums  | \$13,891,270        | \$15,847,726        |
| Intergovernmental   | 6,863,217           | 2,361,997           |
| Interest  | 3,725,832           | 7,347,567           |
| Collection fees   | 2,212,490           | 4,279,228           |
| Miscellaneous   | 40,430              | 26,252              |
|   | <u>26,733,239</u>   | <u>29,862,770</u>   |
| <b>EXPENDITURES</b>   |                     |                     |
| Personal services   | 1,068,100           | 1,464,028           |
| Operating expenses and equipment                                    | 686,298             | 942,658             |
| Department and state overhead                                       | 383,540             | 1,081,561           |
| Contract and collection costs                                       | 5,186,032           | 9,241,553           |
| State share of loan defaults  | 2,350,774           | 9,273,238           |
|   | <u>9,674,744</u>    | <u>22,003,038</u>   |
| Total Expenditures  | <u>9,674,744</u>    | <u>22,003,038</u>   |
| Excess of Revenues Over Expenditures                                | 17,058,495          | 7,859,732           |
| <b>OTHER FINANCING SOURCES</b>                                      |                     |                     |
| Federal advances  | <u>3,648,524</u>    | <u>5,257,061</u>    |
| Excess of Revenues and Other Financing<br>Sources Over Expenditures | 20,707,019          | 13,116,793          |
| Fund Balance, beginning of fiscal year                              | <u>51,578,848</u>   | <u>72,285,867</u>   |
| Fund Balance, end of fiscal year                                    | <u>\$72,285,867</u> | <u>\$85,402,660</u> |

See the notes accompanying the financial statements.



## NOTES TO THE FINANCIAL STATEMENTS

### 1. Definition of Reporting Entity

The State Guaranteed Loan Reserve Fund accounts for the activities of the California Educational Loan Programs, which comprise the State Guaranteed Loan Program and the California Loans to Assist Students Program, plus the residual activities of the Guaranteed Loan Program, which ceased to provide loans in 1967.

### 2. Summary of Significant Accounting Policies

The accompanying financial statements reflect the financial position and results of operations of the State Guaranteed Loan Reserve Fund of the California Student Aid Commission (commission). The financial statements have been prepared in conformity with generally accepted accounting principles applicable to state and local governments. Below is a summary of the more significant accounting policies.

#### A. Fund Accounting

The State Guaranteed Loan Reserve Fund is accounted for as an expendable trust fund. Expendable trust funds account for assets held in a trustee capacity, and both principal and income may be expended in the course of the fund's designated operations.

#### B. Basis of Accounting

The State Guaranteed Loan Reserve Fund is accounted for on the modified accrual basis. Under the modified accrual basis of accounting, revenues are recognized in the accounting period in which they become measurable and available, and expenditures are recognized, if measurable, in the accounting period in which the liability is incurred. The commission charges the costs of sick leave when this benefit is used rather than when it is earned.

### 3. Due From Other Funds

Most of the amount in this account reflects the fund's share of the Surplus Money Investment Fund (SMIF). This amount is available upon demand. The account also includes amounts due from the General Fund and the Personal Income Tax Fund for recoveries of defaulted loans collected by these funds but not remitted to

the State Guaranteed Loan Reserve Fund as of June 30. The following schedule summarizes the account balances at June 30, 1984 and 1985:

|                     | <u>1984</u>         | <u>1985</u>         |
|---------------------|---------------------|---------------------|
| Investment in SMIF  | \$67,031,469        | \$85,981,259        |
| General Fund        | 1,307,887           | 965,522             |
| Personal income tax |                     | <u>73,538</u>       |
| Total               | <u>\$68,339,356</u> | <u>\$87,020,319</u> |

4. Due From Federal Government

This account represents the June 30 balance due from the United States Secretary of Education for amounts billed that are to be reimbursed in the subsequent fiscal year. Included in this account are amounts due for administrative cost allowances and amounts billed for defaulted loans that the commission purchased under a federal reinsurance agreement. (See also Notes 14 and 17.) The following schedule summarizes the amounts due from the federal government as of June 30, 1984 and 1985:

|                           | <u>1984</u>         | <u>1985</u>         |
|---------------------------|---------------------|---------------------|
| Administrative costs      | \$ 4,524,840        | \$ 5,672,676        |
| Defaulted loans purchased | <u>5,524,199</u>    | <u>41,426,464</u>   |
| Total                     | <u>\$10,049,039</u> | <u>\$47,099,140</u> |

The increase in the amount due from the federal government for defaulted loans resulted from a delay in the submission of reimbursement claims to the federal government. The delay occurred because the commission's original spending authority for payment of defaulted loans to lenders was insufficient. (See also Note 5.)

5. Payable to Lenders and Students

This account represents amounts payable to lenders for the purchase of defaulted loans and for amounts refundable to students. Prior to fiscal year 1984-85, the General Fund made defaulted loan purchases and paid refunds on behalf of the State Guaranteed Loan Reserve Fund, which subsequently reimbursed the General Fund. For this reason, this account was not in use in prior years.

At June 30, 1985, \$47,509,546 represents defaulted loans from March through June 1985 that the commission had not purchased from lenders because it had insufficient spending authority. The

commission obtained an increase in spending authority in June. The remainder of \$85,019 represents amounts refundable to students.

6. Due to General Fund

At June 30, 1985, this account represents the unreimbursed operating costs incurred by the General Fund on behalf of the State Guaranteed Loan Reserve Fund. At June 30, 1984, the account also included amounts for purchases of defaulted loans that the General Fund paid on behalf of the State Guaranteed Loan Fund. (See also Note 5.)

7. Due to Federal Government

This account represents collections on defaulted loans less the amount of collection fees that the commission may retain (see Note 15) and the State's share of the individual loan defaults (see Note 17).

8. Reserved for Loan Defaults

The California Administrative Code Title V, Chapter 1, Part IV, Section 30108, requires the commission to maintain a reserve for the purchase of defaulted loans. The commission must deposit to this reserve at least 80 percent of the insurance premium revenue and the interest earnings from federal advances received under Section 422 (c) of the Higher Education Act of 1965. Funds in this reserve may be used only for the purchase of defaulted loans.

9. Designated for Federal Advances

The United States Secretary of Education made advances to the commission to establish or strengthen the State Guaranteed Loan Reserve Fund. These advances may be used only to purchase defaulted loans. An agreement between the commission and the Secretary also specifies that the Secretary at any time may call upon the commission to repay part or all of any advanced monies when the Secretary determines that the fund no longer needs the advanced monies.

10. Lenders' Agreements

The commission's agreements with lending institutions require that it maintain a guarantee reserve fund. This fund must be represented by cash and marketable securities, and it must have a total market value of not less than one percent of the total amount of unpaid principal and interest of all approved notes that are covered by federal reinsurance under the agreement between the commission and the United States Secretary of Education. At June 30, 1985, the commission had a cash balance and investments in the Surplus Money Investment Fund totaling \$86,685,752. These amounts are readily available. Under the agreement with the

lenders, the required balance was \$30.6 million at June 30, 1985, based on the amount of original principal of outstanding notes. The amount of original principal does not reflect amounts paid on the notes, nor does it reflect unpaid interest, neither of which is reported to the commission.

In January 1983, the commission also entered into a guarantee reserve agreement with the California Student Loan Authority, which was established to provide a secondary market for loans to students and parents. This agreement requires that the commission maintain a fund balance reserved for loan defaults in the California Educational Loan Programs. This fund balance must be equal to at least one percent of the unpaid principal amount of all loans guaranteed by the commission. At June 30, 1985, the commission maintained a reserve for loan defaults of \$46,735,420. Under the agreement, the required reserve was \$31,043,003.

#### 11. Retirement Commitments

Regular employees of the commission are members of the Public Employees' Retirement System (PERS), which is a defined benefit, contributory retirement plan. The amount that the commission and its employees contribute to the PERS is determined actuarially under a program in which contributions plus retirement system earnings provide the necessary funds to pay retirement costs as they are accrued. The State Guaranteed Loan Reserve Fund's share of retirement contributions for the fiscal years ended June 30, 1984 and 1985, was \$140,718 and \$178,630, respectively.

#### 12. Compensated Absences

As of July 1, 1984, the commission began accruing amounts for accumulated vacation, compensated time off, and personal holidays to conform with Statement 4 of the National Council on Governmental Accounting. Accordingly, the commission restated the balance sheet as of June 30, 1984, to show an accumulated liability of \$61,164 for compensated absences with a corresponding reduction of the undesignated fund balance. The change in the accounting for compensated absences increased the amount of personal services expenditures for the year ended June 30, 1985, by \$26,400 relative to the previous accounting method, which did not accrue a liability for compensated absences. The effect of the change on the amount of personal services expenditures for the year ended June 30, 1984, has not been determined.

The liability for compensated absences does not include amounts for accumulated sick leave because employees cannot receive cash for sick leave balances when they leave state service. Accumulated sick leave may be exchanged upon retirement for service credits in an employee's retirement account.

13. Insurance Premiums

Student borrowers pay insurance premiums when the lending institutions disburse the loans. The commission must use at least 80 percent of these premiums to underwrite defaulted loans. The remainder may be used to cover costs that the commission incurs in administering the loan program.

14. Intergovernmental Revenue

This amount represents federally reimbursed administrative costs. In previous years, the United States Secretary of Education reimbursed the commission for administrative costs of up to one percent of the outstanding balance of guaranteed loans. For the federal fiscal year 1985, which began on October 1, 1984, the Secretary suspended payment of administrative cost allowances. Therefore, the amount due from the federal government as of June 30, 1985, does not include \$5,205,529 of administrative costs incurred by the commission after September 30, 1984.

15. Collection Fees

The federal government allows guarantee agencies to retain up to 30 percent of loan default recoveries for collection efforts.

16. Contract and Collection Costs

This amount represents payments to E.D.S. Corporation for administrative support services and for collection costs on recoveries of defaulted loans. Under the contract with E.D.S. Corporation, contract fees are calculated at various percentages of the loan amount, depending on whether the loan is classified as guaranteed during the month, as outstanding at the end of the month, or as a defaulted loan purchased during the month. In addition, contract costs include payments for changes in the processing system that the commission requested. The total contract costs were \$3,000,469 and \$3,969,132 for the years ended June 30, 1984 and 1985, respectively. The remainder of each amount represents collection costs of \$2,185,563 and \$5,272,421 for the years ended June 30, 1984 and 1985, respectively.

17. State Share of Loan Defaults

The agreements between the California Student Aid Commission and the lenders participating in the loan program require that the commission purchase guaranteed loans that have been defaulted if the lender has exercised due diligence in making, servicing, and collecting the loan. Likewise, the agreement between the commission and the United States Secretary of Education requires the Secretary to purchase from the commission a percentage of those defaulted loans that the commission purchases from the lenders. Through federal fiscal year ended September 30, 1983, the Secretary purchased 100 percent of the amount of defaulted

loans. However, beginning with the 1983-84 federal fiscal year, the percentage of defaulted loans that the Secretary purchases may vary. During each federal fiscal year, the federal government will purchase 100 percent of the amount of defaulted loans until the total amount of the defaulted loans purchased reaches 5 percent of the amount of loans in repayment status at the end of the preceding federal fiscal year. After the amount of defaulted loans purchased reaches 5 percent of the amount of loans that were in repayment, the federal government will purchase 90 percent of the amounts of defaulted loans. When the amount of the defaulted loans purchased reaches 9 percent of the amount of loans that were in repayment, the federal government will purchase 80 percent of the amount of defaulted loans.

For the year ended June 30, 1985, the federal government purchased \$117 million of the \$126.3 million of defaulted loans. For the year ended June 30, 1984, the federal government purchased \$92.5 million of the \$94.8 million of defaulted loans. The increase in the State's share of defaulted loans from \$2.3 million to \$9.3 million resulted primarily from a decrease in the percentage of the federal share. As indicated in the first paragraph, the applicability of the percentage of federal purchases of defaulted loans changed on October 1, 1983. The change had only a partial effect in the year ended June 30, 1984. The amount for the year ended June 30, 1985, shows the full effect for the first time.

#### 18. Subsequent Events

As explained in Note 14, the United States Secretary of Education suspended payment of administrative cost allowances as of October 1, 1984. However, in October 1985, bills were introduced in the United States Senate and House of Representatives that would amend the Higher Education Act of 1965. The bills mandate federal reimbursement of administrative costs retroactive to October 1, 1984. The bills would also require guarantee agencies to begin repaying federal advances in 1988. At this time, we cannot determine whether these bills will be passed.

### OTHER COMMENTS

As an integral part of our examination, we reviewed the accounting procedures of the California Student Aid Commission and its related system of internal accounting control to the extent we considered necessary to form an opinion on the fairness with which the financial statements of the State Guaranteed Loan Reserve Fund present the fund's financial position and the results of the operations in accordance with generally accepted accounting principles consistently applied. As part of our review, we are issuing a management letter to the commission suggesting action that it should take to improve its administration of the State Guaranteed Loan Reserve Fund.

cc: Members of the Legislature  
Office of the Governor  
Office of the Lieutenant Governor  
State Controller  
Legislative Analyst  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Majority/Minority Consultants  
Capitol Press Corps